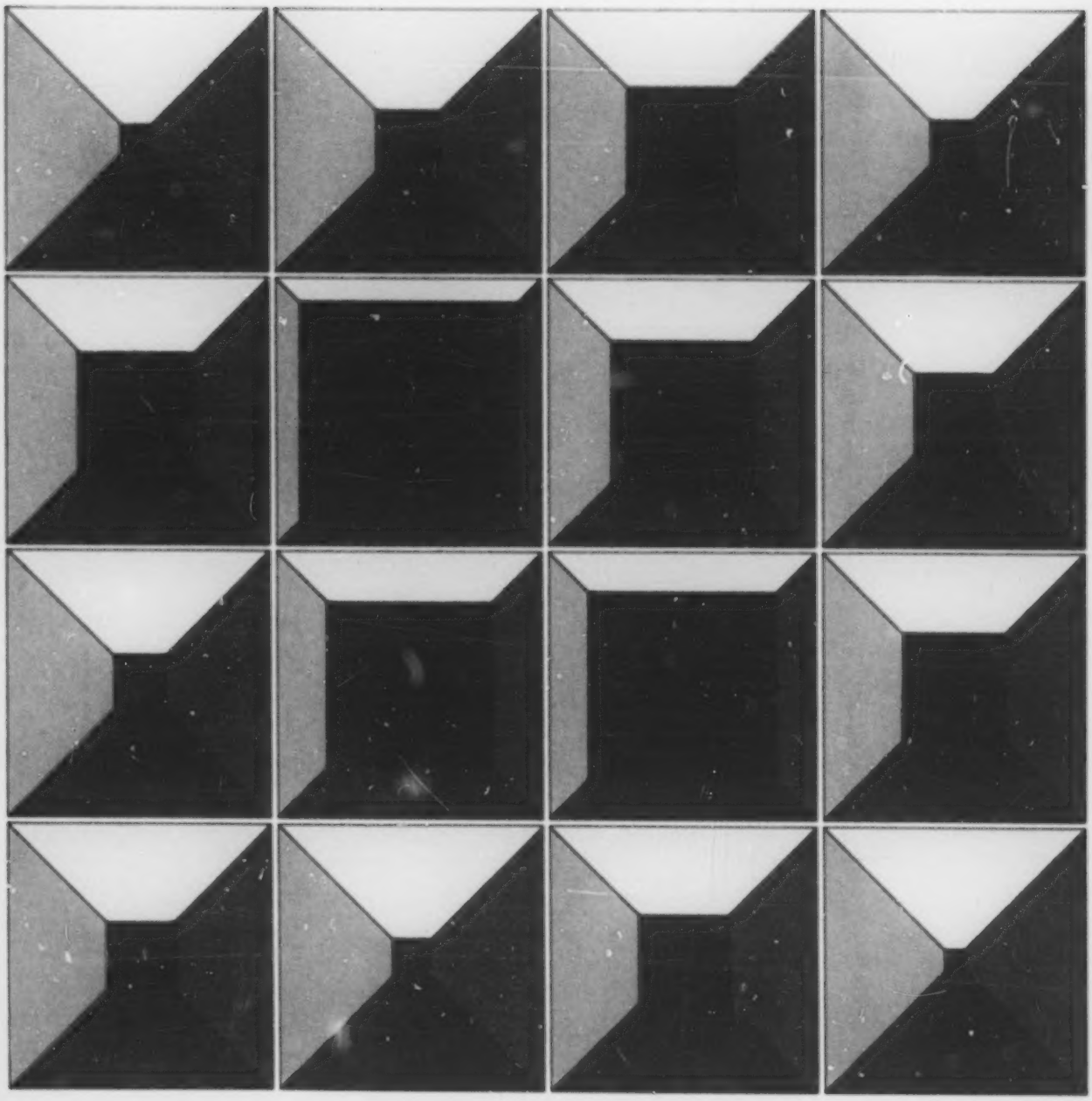
A CBO Study

Curtailing Indirect Federal Subsidies to the U.S. Postal Service

August 1984

Congress of the United States
Congressional Budget Office



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NOTE

Unless otherwise noted, all dates referred to in this paper are fiscal years.

PREFACE

The U. S. Postal Service (USPS) still relies on the federal government to cover a portion of its costs, although 1970 law moved the USPS off-budget with the intention that the service operate as a self-supporting enterprise. Of particular note are the costs of health and pension benefits for USPS retirees. The USPS now covers only two-thirds of these personnel costs, and the federal government covers the balance in "indirect subsidies." As the Congress continues its search for ways to reduce federal costs, the question arises as to whether the government ought to continue subsidizing USPS compensation costs. This paper, undertaken at the request of the Chairman of the House Committee on the Budget, provides analytical background on the size, nature, and effects of these indirect subsidies. The paper also sets out various options for reducing this aspect of federal support.

Sherri Kaplan of the General Government Management staff of CBO's Office of Intergovernmental Relations prepared the paper, under the supervision of Earl A. Armbrust and Stanley L. Greigg. The author gratefully acknowledges the contributions of various other CBO staff members, including R. Mark Musell, who assisted with writing, David DelQuadro, Mary Maginniss, Stacey Sheffrin, Suzanne Schneider, and Michael Tisci. Special thanks go to Johanna Zacharias, who edited the study, and to Mary Pat Gaffney, who typed the various drafts and prepared the paper for publication. In keeping with CBO's mandate to provide objective analysis, the study offers no recommendations.

Rudolph G. Penner
Director

August 1984

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SUMMARY

A vestige of the time when postal operations were performed by a federal agency, participation in the Civil Service Retirement (CSR) and Federal Employees Health Benefit (FEHB) systems is still available to the 1.02 million active and retired personnel of the U.S. Postal Service (USPS). The USPS, now an off-budget public enterprise designed to be financially self-sufficient, pays somewhat more than two-thirds of the full costs of pension and health benefits not covered by its employees and annuitants. The U.S. Treasury pays the remainder as "indirect subsidies," reducing USPS operating expenses but contributing to federal deficits. The amounts covered by the Treasury stand at $0.8 billion in 1984 and will accumulate to $4.4 billion by 1989. Should the government continue to subsidize part of USPS compensation costs, or should the USPS pay the full costs? In a debate on the USPS's indirect subsidies, the Congress may wish to consider:

- The sizes and costs of the subsidies,
- Their effects on USPS operations, and
- Possible options for their reduction or elimination.

THE DEBATE OVER CONTINUED INDIRECT SUBSIDIES

Supporters of current practice believe that eliminating the subsidy could increase upward pressures on postage rates. Opponents view moving the mail as an enterprise benefiting specific individuals and organizations that should bear the full costs of the services the USPS offers. From this perspective, ratepayers, not taxpayers, should bear the full costs of compensating USPS personnel. The USPS itself views its employees' continued coverage under the CSR and FEHB programs as burdensome costs imposed on them under the Postal Reorganization Act of 1970, which, while continuing CSR and FEHB coverage for postal workers, prohibited the USPS from negotiating benefit reductions. Still other critics of the status quo cite both the importance of proper cost recognition and the unfair competitive edge the USPS gains from indirect subsidization of operating costs. Competitors in the private sector, ranging from small courier services to major telephone companies, face what some observers regard as an unfair advantage for the USPS attributable to the service's subsidized rates. Within the USPS decisions concerning the allocation of resources

between labor and capital investment (including applications of new technologies) may also be distorted by artifically depressed USPS labor costs.

INDIRECT SUBSIDIES IN THE CONTEXT OF USPS FINANCING

Two revenue sources account for most of the USPS's yearly income: stamp sales (roughly 90 percent) and federal appropriations (roughly 3.5 percent), also called direct subsidies. The latter help support low postal rates for so-called "preferred mailers." A portion of the USPS's costs--about 3 percent--are avoided by indirect subsidization. If instead the USPS undertook the costs avoided by indirect subsidization, federal appropriations would not necessarily rise. Rather, all postage rates--albeit to differing degrees--could increase to take up the slack.

The USPS spends by far the largest share of its revenue--in 1984, $25 billion--on employee compensation. Salaries will cost the USPS some $18.3 billion this year, and health and retirement benefits about $2.8 billion annually. The latter represents more than 10 percent of employee compensation expenses. Amounts not covered by the USPS or participants, and eventually subsidized by the Treasury, average some $0.9 billion a year. Over the next five years, these costs could total about $4.4 billion, almost all of that sum occasioned by CSR.

Calculating the Costs of Annuitants' Health Benefits

While a USPS employee is actively working, he or she and the service share the full cost of his health benefits. With that person's retirement, however, USPS payments stop, and the federal government picks up the employer's share of benefit costs--about 55 percent of premiums. Most of the 370,000 USPS retirees or their survivors are enrolled in the FEHB program. For those USPS employees projected to retire through 1989, the amounts that shift to the government as indirect subsidies could reach $0.1 billion in that year and could total nearly $0.4 billion over the 1985-1989 period.

Calculating the Costs of Pensions

Nearly all of the USPS's 650,000 active employees participate in the CSR system. Payments from the USPS to the system, totaling $1.9 billion in 1984, fail to fund the full federal cost of earned benefits for current workers. For CSR alone, this annual shortfall or indirect subsidy--estimated at $0.8 billion in 1989--could total some $4.0 billion by the end of 1989. (This

Congressional Budget Office estimate of the indirect retirement subsidy reflects the difference between payments toward future benefits made by the USPS and its employees, and the annual amounts as a percent of salary--"accrual cost"--that would be required to fund those benefits.) The USPS currently makes two payments to the CSR program. One, equivalent to 7 percent of pay, matches employees' contributions; the other amortizes, over 30 years, the increased retirement liabilities associated with negotiated wage adjustments. (The estimates assume a continuation of the 30-year amortization payments at their present level.)

For the current USPS work force, CBO estimates that the accrual cost, less employee contributions, totals about 13 percent of payroll. If set aside throughout the careers of current workers, this amount, together with employees' contributions, would provide a sufficient accumulation to cover expected retirement benefits. (Any attempt to estimate future CSR benefits as a cost that accrues during a worker's active employment is somewhat uncertain, particularly concerning appropriate economic assumptions and actuarial methods.) The CBO estimate runs about 16 percentage points lower than the most recent 29.5 percent estimate published by the CSR Board of Actuaries. The lower CBO estimate results mainly from use of economic assumptions concerning pay raises, interest, and inflation that reflect conditions during past and projected periods of participation by current USPS employees in the CSR program. The estimate also reflects differences in assumptions about life expectancy and in the demographic characteristics of the population groups covered. CBO used the current USPS work force, whereas the Board of Actuaries used all new federal workers. Applying the CBO accrual cost estimate, the indirect subsidy for pension benefits is the equivalent of 6 percent of payroll in 1984.

Calculating the Costs of Cost-of-Living Adjustments to Wages

Current methods of setting amortization payments and employee and employer contributions for negotiated pay raises tied to the cost of living, although adequate in the long run, result in lower near-term payments to the Treasury. Earlier scheduling of payments for wage cost-of-living adjustments (COLAs) under labor contracts now in force could have reduced the deficit since 1979 by $2.5 billion (in 1984 dollars). However, the current payment practice of calculating liabilities attributable to wage COLAs reflect an interest rate both below the rate currently received on investments of the CSR fund.

OPTIONS

Should the Congress decide to curtail indirect subsidies, it could adopt several approaches. Each of the three options analyzed by CBO would reduce subsidies by increasing contributions from the USPS to the federal government. Increased contributions--recorded in the budget as offsets to outlays--could somewhat narrow federal budget deficits by amounts accumulating to $3.0 billion if changes were phased in over four years (see Summary Table). (Budgetary estimates have been adjusted to reflect secondary effects, including a slight rise in federal mailing costs that would occur if eliminating the subsidy caused higher postage rates.) The first two options CBO has examined--recouping health-benefit and retirement costs--could be implemented together, as shown in Option III.

SUMMARY TABLE. PROJECTED FEDERAL DEFICIT REDUCTIONS RESULTING FROM OPTIONS TO ELIMINATE INDIRECT SUBSIDIES TO THE USPS, 1985-1989 (In billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Reductions a/
Option I -- Recoup Annuitants' Health-Benefit Costs	b/	b/	0.1	0.1	0.1	0.4
Option II -- Recoup Pension Costs	0.2	0.4	0.6	0.7	0.6	2.6
Option III -- Recoup Annuitant Health-Care and Pension Costs	0.3	0.5	0.7	0.8	0.8	3.0

SOURCE: Congressional Budget Office.

a. Details may not add to totals because of rounding

b. Less than $50 million.

Option I--Recoup Annuitant Health-Care Costs

If the federal cost of health insurance for newly retired USPS employees were shifted to the USPS, federal budget deficits would decline by amounts accumulating to $0.4 billion over the 1985-1989 period. The higher contributions would not noticeably increase the USPS's operating costs. Proponents of such a course argue that the USPS, operating in the manner of a business, should bear the full cost of annuitants' health coverage; this would be consistent with the practices of many private firms. Arguing from a different perspective, opponents note that the option would impose requirements on the USPS that do not apply to ordinary federal agencies.

Option II--Recoup Pension Costs

Under this option, a USPS contribution of 13 percent of payroll--reflecting the full cost of postal workers' pensions, offset by active employees' contributions--would replace the current USPS agency contributions. In addition, the special amortization payment would remain at the 1985 level. To moderate effects on USPS expenses, the option would phase in full funding over four years. Through 1989, recoupment of the CSR accrual costs could reduce budget deficits by an accumulated $2.6 billion.

Full recovery of retirement costs would be consistent with the Congress' 1983 action on the military retirement program, with federally prescribed private-sector funding practices, and with USPS accounting practices covering other costs. Opponents, noting that no comprehensive valuation of CSR costs for postal employees has ever been conducted, point to the difficulties of estimating normal cost. Even slight changes in the economic assumptions on which such estimates are based, they argue, could mean large fluctuations in USPS operating costs. Other critics would at least postpone any such move, pending Congressional action on several CSR reform proposals and completion of labor negotiations now in progress.

Option III--Recoup Annuitant Health-Care and Pension Costs

Merging Options I and II, this approach would eliminate the indirect subsidies and reduce the federal budget deficit by a cumulative $3.0 billion through 1989. Eliminating indirect subsidies to the USPS could eventually cause postage rates to go up by roughly 5 percent, while mail volume could diminish--albeit only slightly--by 2 percent. According to CBO estimates, both rates and volume effects would differ only slightly by class of mail.

Effects on mail volume would reflect some combination of changes both in the overall amount of mailing and in the share of mail handled by the USPS rather than by its private-sector competitors. Limited information suggests that the USPS's share of certain markets--notably parcel handling, expedited mail delivery, and advertising--may be influenced less by USPS rates' being held down by indirect subsidies than by quality of service.

CHAPTER I. INDIRECT SUBSIDIES IN THE CONTEXT OF A "SELF-SUPPORTING" POSTAL SERVICE

Though designed to operate in the manner of a private corporation, the United States Postal Service (USPS) retains certain features of a federal agency. Since creation of the off-budget USPS under the Postal Reorganization Act of 1970 (Public Law 91-375), postal employees have continued to be covered under the federal Civil Service Retirement (CSR) and Federal Employees Health Benefit (FEHB) programs. Most of the 650,000 active and 370,000 retired postal workers and their widowed spouses now on the USPS rolls are covered by the CSR program, and most annuitants receive benefits under the FEHB program.

The costs of providing these employment benefits are not fully covered by revenues of the USPS, although the 1970 act stipulated that the service achieve financial self-sufficiency while maintaining nationwide mail service at reasonable and uniform rates. A portion of these benefits' costs comes not from stamp sales but from the U.S. Treasury as "indirect subsidies." 1/ Should the Congress take up the issue of indirect subsidies, several fundamental questions may arise:

- What is the nature of the indirect postal subsidies, and how are they measured?
- How do the indirect subsidies affect the costs of USPS operations? and
- What alternatives are available to eliminate or reduce the indirect subsidies, and how would they affect postal users and the USPS's competitors?

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1. The USPS may also receive other indirect federal subsidies not treated in this paper. For example, the USPS uses federal facilities maintained by the General Services Administration to store records for various federal agencies, but at no charge.

USPS COMPENSATION COSTS

Employees' compensation represents by far the USPS's largest expense. In 1984, roughly 85 percent--or some $22 billion--of the total cost of postal operations will arise from salaries and benefits. (Other expenses include maintenance of vehicles, rents on real property, fuel and other utilities, supplies, and equipment maintenance.) Within the compensation category, salaries alone represent close to 85 percent of costs, or $18.3 billion; the remaining $3.6 billion covers fringe benefits. Current charges for retirement and health coverage make up more than three-fourths of the costs of all fringe benefits together (see Table 1). Though salaries and some other features of compensation are decided through negotiations between USPS management and postal employees' unions, the level of CSR and health-care benefits are excluded by statute from collective bargaining. 2/ The portion of health-care premiums paid by the USPS, however, is subject to negotiation. Total postal costs, as well as the relative portion for compensation, will rise slightly in 1985 and subsequent years, when the combined full-year effects of recently enacted changes in Medicare and Social Security taxes become effective. 3/

The Current Indirect Subsidies

For its current work force, the USPS pays only about 70 percent of the full cost of pensions and annuitants' health coverage not paid by active and retired employees; current law assigns the remainder of these costs to certain accounts in the federal budget. Thus, some USPS operating expenses and the revenue requirements to cover them are held down, contributing to pressure on the federal budget deficits. Annual compensation costs diverted from the USPS to the federal budget--the USPS's indirect subsidies--stand

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2. The 1970 Act established a policy of labor negotiations for the USPS. However, this law protects benefits by disallowing any change that results in a fringe benefit package less favorable than what was available to employees of the old Post Office Department in 1970.

3. Since January 1983, the USPS has been required to contribute to the Medicare program 1.3 percent of salary up to a current salary limit of $37,800 per employee. In addition, since January 1984, the USPS contributes to the Social Security fund for all its new employees an additional 5.7 percent of each employee's salary up to $37,800. (The salary level used to calculate contributions changes annually according to increases in average hourly earnings.)

TABLE 1. CHARGES TO THE USPS FOR PERSONNEL COMPENSATION, 1984

Components of Costs	Dollars (In billions)	Percent
Salary	18.3	84
Benefits		
Retirement	1.9	9
Health coverage	0.9	4
Workers' compensation	0.3	1
Life insurance	0.1	a/
Medicare	0.2	1
Other b/	0.2	1
Subtotal	3.6	16
Total Compensation	21.9	100

SOURCE: Congressional Budget Office from data in The Budget of the United States Government, Fiscal Year 1985, Appendix.

a. Less than 0.5 percent.

b. Includes payments from the USPS for unemployment benefits and Social Security benefits for temporary and newly hired personnel.

at $0.8 billion in 1984 and could accumulate to about $4.4 billion by the end of the 1985-1989 period. The ultimate source of these subsidies is the general taxpayer.

CONGRESSIONAL CONSIDERATIONS

Should standing retirement and health-benefit subsidies to the USPS remain in effect? Past Congressional debate and action on postal subsidies have focused primarily on direct appropriations to the USPS and not on the

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growing indirect subsidies. 4/ The remainder of this chapter outlines isues the 98th Congress may debate and closes with an overview of USPS financing.

Issues in the Debate

In the past, the USPS has supported the principle of paying the full costs of employee benefits, though it has cautioned that repeated changes in estimates of the appropriate contributions--which are highly sensitive to underlying economic assumptions--could cause problems in setting postage rates. 5/ Today, the question of indirect subsidies draws widespread controversy, with strong arguments on both sides. In addition, the climate of rapid technological questions raises special concerns. Even if the USPS continues its relatively limited role in the now-burgeoning business of electronic mail, the Congress may still consider whether market choices by customers using traditional USPS services should be influenced by postal prices artificially depressed--albeit, by small amounts--by continuation of the indirect subsidies. From this perspective, continuing the indirect subsidies seems inconsistent with recent governmental actions to free up market forces in the transportation and communications industries. 6/

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4. For analysis of certain "direct subsidies" to the USPS, see Congressional Budget Office, Charging for Federal Services (December 1983), Chapter VI and Reducing the Deficit: Spending and Revenue Options (February 1984), pp. 139-140. An additional appropriation, not treated in this study, covers USPS liabilities created before postal reorganization for accrued but unused annual leave and employees' compensation for injuries. This payment totaled $68 million in 1981. Funding for 1982, 1983 and 1984, estimated by the USPS at $69 million, $71 million and $57 million, respectively, has been deferred until 1985 by the Omnibus Reconciliation Act of 1981 (P.L. 97-35).

5. See letter to the Honorable Elmer B. Staats, Comptroller General of the United States, from Benjamin F. Bailer, Postmaster General, June 3, 1977.

6. See for example Congressional Budget Office, Charging for Federal Services and The Changing Telephone Industry: Access Charges, Universal Service and Local Rates (June 1984).

The Case for the Status Quo. Advocates of the current system view existing health and retirement programs as costly carryovers from before the reorganization of 1970, when employees of the old Post Office worked directly for the federal government. As part of the reorganization, these observers note, the Congress enacted legislation mandating continued participation by postal employees in federal retirement and health programs and prohibited the USPS from negotiating benefit reductions. From this perspective, charging the USPS the full cost of benefits it has no authority to negotiate is seen as unfair. While acknowledging that programmatic and budgetary decisions might improve if full federal costs were charged to the USPS, proponents of the current system note that planning has evolved from existing financing arrangements. Eliminating indirect subsidies, they argue, might add to pressure for short-term operating deficits and/or long-term rate hikes.

The Case for Change. Opponents of current practice point out that, as reorganized, the USPS is intended to be largely self-supporting. They view moving the mail as an enterprise that serves specific individuals and organizations--mailers--who should bear the full costs of postal service. From this perspective, the current system of benefit financing that results in indirect subsidies for USPS operating costs should be modified, and the cost of USPS benefits shifted from taxpayers to the service itself and to its users. Critics also contend that the artificially low postage rates resulting from the indirect subsidies give the USPS an unfair advantage over its private-sector competitors (ranging from small courier services, to such large common carriers as the United Parcel Service and even telephone companies) and cause overuse of some classes of USPS service. In many categories of mail service, the USPS represents only a small portion of a broader market devoted to serving similar needs. Discontinuing the subsidy, they argue, would save the government money and, at the same time, would support a better allocation of resources within both the USPS and throughout the communications industry. A final concern, noted by the General Accounting Office (GAO), is that indirect subsidies preclude an accurate accounting of USPS operating costs. 7/ The importance of proper cost allocation appears likely to grow in coming years, as the USPS plans investments in new mail technologies.

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7. See General Accounting Office, Federal Retirement Systems: Unrecognized Costs, Inadequate Funding, Inconsistent Benefits (August 3, 1977). Contrary to the GAO view, some advocates of the status quo contend that, as long as the costs of moving the mail are charged to the public, it makes little difference whether they fall to taxpayers or to postage ratepayers. But this position overlooks the fact that most postal ratepayers, in contrast to taxpayers, are businesses and not-for-profit organizations. In addition, charging ratepayers more closely associates costs with use of mail service.

Issues Arising from Technological Progress. The continuing revolution in communications technology and the proliferation of firms using services that compete with traditional USPS markets will probably change how USPS customers do business--with potentially profound effects on mail volume, rates, service levels, and USPS labor force requirements. 8/ The effect of indirect subsidies on the basic course and pace of technological change in postal operations is likely to be minor, but artificially depressed USPS labor costs may have potential to distort both decisions made within the USPS concerning automation and choices made throughout the communications industry concerning marketing and allocation of resources. 9/ How the USPS should respond to the challenge presented by new technologies is much debated.

Regardless of the types of actions finally taken, they should be founded on a full and accurate accounting of USPS costs--especially those for employee pay and benefits. If the USPS moves to expand electronic mail service, decisions about use of labor and about capital investment in new technologies would be improved by adoption of the full costs of employee compensation, which makes up such a large portion of total postal costs. Similarly, should some form of assistance be desired to aid research and development (R&D) at the USPS, direct appropriations earmarked for R&D and fully reflected in current accounting could always replace current indirect subsidies.

HOW USPS FINANCING WORKS

In keeping with its mandate to operate in a businesslike manner, the USPS generates most of its revenue from the sale of postage stamps, and it

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8. The extent of technological change is illustrated by the MCI Communications System's recent introduction of electronic mail service. MCI offers both businesses and households the opportunity to transmit messages instantly between compatible devices at a rate of $1.00 for up to five pages. In addition, the American Telephone and Telegraph Company (AT&T) has recently announced its entry into the computer market, stressing sale of desktop equipment that can link multiple individual users in local area networks.

9. For a general discussion of the potential impact on the USPS of new technologies, see National Academy of Public Admininstration, Evaluation of the United States Postal Service (July 1, 1982), pp. 167-184 and Office of Technology Assessment, Implications of Electronic Mail and Message Systems for the U.S. Postal Service (August 1982).

spends most of that revenue to compensate its employees. In 1984, the USPS estimates that it will end the year with a deficit of about $730 million--about 3 percent of total operating expenses. 10/ The USPS has incurred net operating losses in nine of the last 12 years, despite improvements in productivity and assistance from both direct and indirect federal subsidies. 11/ But these deficits are small in comparison to the total USPS budget--averaging over the 12-year period about 3 percent of annual operating expenses (see Figure 1).

Projecting future deficits of $2.2 billion for 1985, the USPS has filed for postage increases that would boost first-class rates from 20 cents for the first half-ounce to 23 cents. 12/ The basis for the proposed increase will undergo extensive review both by customers and by the independent U.S. Postal Rate Commission. What conclusions will emerge from such review are uncertain.

Revenues and Direct Appropriations

In 1984, USPS revenues will total an estimated $25 billion, of which more than 90 percent will derive from the sale of postage stamps, with first-class mail alone estimated to account for slightly under three-fifths of total revenues. The USPS sets rates to recover costs on a fair and equitable basis, subject to specific criteria laid out by the rate commission. 13/ Most income not from postage comes from interest on investments, rental of post

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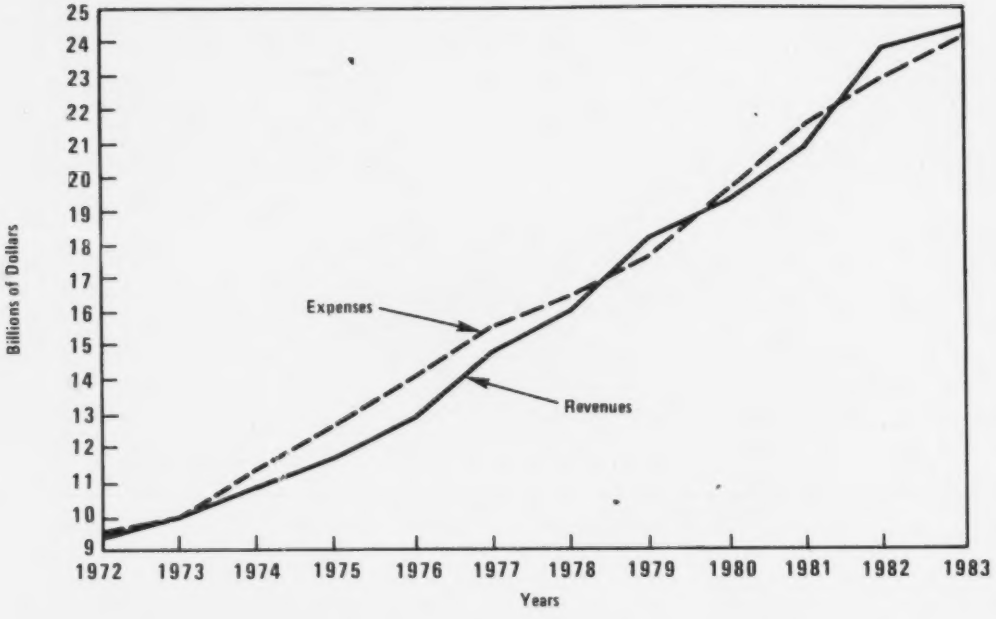
10. See The Budget of the United States Government, Fiscal Year 1985, Appendix, p. III-12

11. See Bernevia McCalip, The Proposed Postal Service Subsidy Budget Cuts: Issues and Possible Consequences, Congressional Research Service (September 30, 1982), p. 12.

12. See U.S. Budget Appendix for 1985, p. III-12, and the United States Postal Service, Request of the United States Postal Service for a Recommended Decision on Changes in Rates of Postage and Fees for Postal Services (November 10, 1983).

13. For discussion of postage rate setting, see Michelle Gilbert, "Postal Politics--The Interest Groups Find Out That Pressure Can Still Work," National Journal (July 30, 1983), pp. 1598-1599, and the General Accounting Office, A Case Study of Why Some Postal Rate Commission Decisions Took As Long As They Did (September 8, 1981).

Figure 1.
USPS Revenues and Expenses, 1972-1983
(In billions of dollars)



SOURCE: Congressional Budget Office from data provided by the U. S. Postal Service.

NOTE: In years in which USPS revenues exceeded expenses, the surplus monies were used to reduce the USPS' outstanding debt.

office boxes, fees for money orders and other special services, and direct federal appropriations authorized by the reorganization act of 1970.

The direct federal appropriations are of two types. First, a "revenue-forgone appropriation" reimburses the USPS for providing free service to blind and otherwise handicapped persons and for reducing second-, third-, and fourth-class postage for certain other "preferred mailers"--mainly religious and other not-for-profit organizations, small newspapers, libraries, and educational institutions. In the past, a second appropriation, referred to as a "public service payment," helped finance operations that do not pay for themselves--such as postal facilities in remote areas and mail delivery on Saturdays. Throughout the 1970s, the two types of direct appropriations

together accounted for about 12 percent of average annual USPS income; today, though, direct appropriations account for only about 3.5 percent. Under authority of the Omnibus Reconciliation Act of 1982, the public service payments were discontinued last year.

Direct and indirect subsidies are related only loosely. Without indirect subsidies, postage rates for all mail users would increase (see Chapter III). Because added costs can be associated with various classes of mail, they would cause higher postage rates for preferred mailers, and thus might also increase the requirements for the direct revenue forgone subsidy. The Congress could either increase the direct appropriation to meet the higher requirement--thus keeping rates down for preferred mailers--or approve a lower level of funding. Conversely, changes in the level of revenue forgone appropriations would not affect the level of the indirect subsidies.

CHAPTER II. THE INDIRECT SUBSIDIES TO THE USPS AND THEIR COSTS

With the U.S. Postal Service not paying the full costs of personnel benefits, the amounts the Treasury covers never become cost requirements on the USPS's books, even though they arise from USPS operations. Avoided yearly retirement and health-coverage costs now come to $0.8 billion, and they could accumulate to $4.4 billion over the next five years (see Table 2). This chapter details the financial mechanisms that give rise to these indirect subsidies to the USPS, focusing first on health-coverage costs and next--in greater detail--on retirement costs. (The indirect subsidies described do not include calculation of liabilities created by past funding deficiencies.)

TABLE 2. ESTIMATED INDIRECT SUBSIDIES TO THE USPS FOR DEFERRED BENEFITS TO CURRENT WORKERS, 1984-1989 (In billions of dollars)

Cost Element	1984	Projected 1985	1986	1987	1988	1989	Cumulative Five-Year Projections
Health Coverage	a/	a/	a/	0.1	0.1	0.1	0.4
Pensions	0.8	0.9	0.9	0.8	0.7	0.6	4.0
Total	0.8	1.0	0.9	0.9	0.8	0.8	4.4

SOURCE: Congressional Budget Office

NOTE: Details may not add to totals because of rounding.

a. Less than $50 million.

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ANNUITANTS' HEALTH COVERAGE

Like many private firms, the federal government provides health-insurance coverage for its retired personnel. Most retired USPS workers, along with active and retired federal civil servants, receive such protection under the Federal Employees Health Benefits program. 1/ The FEHB program offers an array of plans of varying forms of coverage and costs.

All annuitants under the FEHB program tend to receive less comprehensive but costlier health coverage than is available to private-sector employees. 2/ This disparity stems mainly from two causes. Most federal workers retire before they meet the age requirements for Medicare. And because some 20 percent of all current federal annuitants never contributed to Medicare, they are not eligible for Medicare benefits. 3/ Since January 1983, however, all federal workers have been required to participate in Medicare; all federal annuitants eventually will therefore be covered, and differences from the private sector will diminish. While a USPS employee is still an active worker, he or she shares the cost of health benefits with the USPS. Upon his or her retirement, however, USPS contributions stop. Roughly 95 percent of postal annuitants elect continued participation in FEHB, and they contribute slightly more than 45 percent of

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1. The FEHB program operates on a "pay-as-you-go" basis. Contributions from enrollees and employing agencies, plus appropriations from the general fund of the Treasury, cover the premium costs of participants. See also CBO, Reducing the Reserves of the Federal Employees Health Benefit Program (June 1981).

2. See General Accounting Office, Financial and Other Problems Facing the Federal Employees Health Insurance Program (February 28, 1983) and U.S. House of Representatives, Committee on Post Office and Civil Service print, Review of the Federal Employees Health Benefits Program (January 28, 1983).

3. FEHB coverage for about 84 percent of postal annuitants age 65 and older becomes secondary to Medicare. When this occurs, FEHB premium rates do not change, but coverage applies only to expenses not paid by Medicare. See the General Accounting Office, Eligibility of Civil Service Annuitants, Survivors, and Employees for Medicare (March 10, 1983), pp. 10-11.

premium costs. The federal government contributes the remainder, providing an indirect subsidy to USPS operations. 4/

In 1984, annual federal FEHB costs for all currently retired USPS employees are estimated to generate an operating subsidy of some $0.3 billion. If, however, calculations were limited to postal employees first retiring this year, the subsidy would come to approximately $20 million in the first year only. But increases in both the number of post-1984 annuitants and health-care costs are expected to push this annual subsidy to about $140 million by 1989.

PENSIONS

The Civil Service Retirement system currently provides retirement, disability, and survivor protection to some 2.7 million postal and other federal employees. 5/ For current workers, benefits under the CSR program are generally considered liberal compared to pension plans typically available in the private sector, because of the availability of full benefits at age 55 and an annual annuity cost-of-living adjustment (COLA) calculated to capture the full increase in inflation as measured by the Consumer Price

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4. The estimated average 45 percent annuitants' share (assumed in this study to be the same for postal and other annuitants) results from uniform dollar contributions made by the government under a statutory formula. The formula sets the contributions for self and for family coverage at 60 percent of the average premium of the six largest participating insurance plans, not to exceed 75 percent of the premium of any one plan. Annuitants contribute more than 40 percent because they tend to participate in plans with above-average costs.

5. As of January 1984, all newly hired federal employees are required to participate in Social Security. Until a supplemental pension plan is developed (or until January 1986, whichever is sooner), these employees will also contribute to CSR at a reduced level. Payments from the Treasury to the CSR fund will make up the difference between the temporary lower employee contribution and the 7 percent of pay contribution. This payment can be regarded as another form of indirect subsidy; however, like the temporary employee contributions it will end when a new pension plan is developed. Because the design of the new plan is still undecided new employees have been excluded from the analyses in this paper.

Index (CPI). 6/ If private-sector employees' participation in Social Security and in employer-provided thrift plans are considered, however, the comparative advantage from these CSR provisions diminishes.

Estimated pension benefit payments to USPS annuitants will total $4.4 billion in 1984, or about 20 percent of the year's CSR payments for all federal annuitants. The current financing of CSR allows the USPS to avoid paying the full federal costs of CSR benefits as they accrue, with the costs avoided eventually paid by the general taxpayer. 7/ The Congressional Budget Office estimates the annual accrual costs not charged to the USPS at some $0.8 billion. Amounts required to fund future CSR benefits fully--referred to here as "estimated accrual cost" and expressed as a level percent of payroll--represent the portion of salary or wages that, if set aside throughout employees' careers, would accumulate enough (with interest) to cover future benefit payments for all current employees together. This cost measure moves in proportion to changes in the size of the payroll, and thus it shows retirement as an expense that accrues with the level and cost of work being performed--in this case, the delivery of mail.

The Indirect Postal Subsidy

As CSR now operates, most employees--including USPS personnel--contribute 7 percent of pay toward the cost of their future CSR benefits. The USPS, as employer, makes two payments for the cost of employee

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6. The Omnibus Reconciliation Act of 1982 provides that civil service retirees younger than age 62 will receive COLAs guaranteed to equal at least 3.3 percent, 3.6 percent, and 3.3 percent, in 1983, 1984, and 1985, respectively. In addition, the Omnibus Budget Resolution for 1984 effectively eliminates the 1984 COLA by establishing annual January adjustments beginning in 1985.

7. The full accrual cost, or normal cost, stated mathetically equals the present value of future benefits for a constant or standardized group of employees divided by the present value of salary throughout the group's collective years of work.

retirement. 8/ One, set at 7 percent of pay, matches the employee contribution; the other, referred to as the "amortization payment," helps cover the future benefit increases that result from past negotiated pay raises. Because pay raises increase future retirement liabilities, they increase the salary base used to calculate an annuitant's initial benefits. (Certain timing problems in the reimbursement for such costs are described below.) The USPS matching contribution fails to fund the full federal expense of future benefits, because it covers neither cost increases associated with COLAs granted annually to CSR annuitants nor the full cost of future pay raises. Because all costs are not considered in the USPS payments, the USPS gains an indirect subsidy that eventually increases annual federal appropriations to the CSR program. As shown below, the subsidy will total some $0.8 billion in 1984.

ESTIMATED 1984 CSR COSTS NOT FUNDED BY THE USPS

	Percent of Payroll	Billions of Dollars
Total amount required to fully fund future benefits for current USPS employees (estimated accrual cost)	20	2.6
Offset by employees' contributions (-)	-7	-0.9
Offset by USPS matching contributions (-)	-7	-0.9
Net estimated indirect subsidy	6	0.8

8. Like the USPS and its employees, most federal workers and their employing agencies contribute 7 percent of pay to CSR. Payments from employers and employees are deposited into the CSR trust fund, the vehicle used in the federal budget to account for the retirement program. Benefit payments to annuitants are made from the same fund. For more information, see Congressional Budget Office, Civil Service Retirement: Financing and Costs (May 1981).

If in 1984 payments to CSR from the USPS were based on the full accrued cost, the so-called matching contribution would rise from 7 percent of payroll to some 13 percent. The effect of this rise on the USPS would be partly offset in future years, however, because future pay raises would no longer trigger increases in the level of amortization payments.

According to CBO's projections, the annual indirect subsidy will increase to $0.9 billion in 1985 and then average about $0.8 billion in the following four years (see Table 3). The decline reflects growth in USPS contributions attributable to current practices used in calculating such payments. (See discussion on retirement costs and COLAs later in this chapter.) The amounts also reflect the net effect of payroll increases for negotiated pay adjustments, including those tied to the CPI, and payroll decreases for current workers who leave active service. (Isolating the costs of retirement for current workers should not imply that the USPS will not continue to fill vacancies by hiring new employees, covered by an as-yet-undecided retirement system.)

Estimating Accrual Costs. Estimating a particular accrual cost for retirement benefits is always subject to some uncertainty. Any result will be influenced by the demographic characteristics of the population being analyzed (such as rates of turnover and distribution by age, sex, and years of service) and even more so by long-term assumptions about real annual rates of interest and inflation and wage increases. Analysis by Office of Personnel Management (OPM) staff illustrates the strong influence of economic assumptions on accrual cost estimates. Applied to a group of new postal and nonpostal employees, an assumed 1 percent increase in the interest rate can decrease by about 22 percent the estimated accrual cost of the CSR system (see Table 4). On the other hand, a comparable increase in long-term annual pay rates can push up the cost estimate by about 12 percent. The sensitivity estimates CBO has derived are based on constant rates assumed for the entire period, rather than on variable rates with yearly changes.

Though no comprehensive actuarial valuation of CSR benefits as they apply to the characteristics of the current USPS work force is available, the CBO estimates the CSR accrual cost for current postal employees to be about 20 percent of payroll. This estimated rate reflects the cost of future retirement benefits on the basis of past and future service. Because the rate is not applied to the USPS retroactively, however, it does not address any liabilities associated with past underfunding.

TABLE 3. INDIRECT USPS PENSION SUBSIDIES UNDER CURRENT CSR FINANCING, 1984-1989 (In billions of dollars)

	1984	Projected 1985	1986	1987	1988	1989	Cumulative Five-Year Projections
			COSTS				
Full Accrual Cost	2.6	3.1	3.1	3.1	3.3	3.2	15.8
Amortization Payments for Past Pay Raises [a]	1.0	1.3	1.3	1.3	1.3	1.3	6.5
Combined Retirement Costs	3.5	4.4	4.4	4.4	4.6	4.5	22.3
			OFFSETS (-)				
Employees' Contributions	-0.9	-1.1	-1.1	-1.1	-1.1	-1.1	-5.5
USPS Payments [b]	-1.9	-2.4	-2.4	-2.5	-2.7	-2.8	-12.8
Combined Offsets	-2.8	-3.5	-3.5	-3.6	-3.9	-3.9	-18.4
			NET INDIRECT SUBSIDY				
Total	0.8	0.9	0.9	0.8	0.7	0.6	4.0

SOURCE: Congressional Budget Office.

NOTE: Details may not add to totals because of rounding.

a. Estimates do not reflect pay raises expected after 1985.

b. Includes 7 percent USPS contributions and amortization payments for past pay raises and pay raises expected under CBO baseline projections, through 1989.

TABLE 4. SENSITIVITY OF CSR ACCRUAL COST ESTIMATES TO CHANGED ECONOMIC ASSUMPTIONS

Assumptions	0.5 Percentage Point Change	1 Percentage Point Change
Lower Annual Rates		
Interest	13	28
Inflation	-6	-11
Salary	-5	-10
Higher Annual Rates		
Interest	-12	-22
Inflation	6	13
Salary	6	12

SOURCE: Congressional Budget Office from analysis in April 30, 1980 memorandum of Edwin C. Hustead, Chief Actuary, to Gary R. Nelson, Associate Director for Compensation, Office of Personnel Management.

The CBO accrual cost estimate incorporates both historical and projected economic data developed by CBO, and it applies only to the current USPS work force. 9/ For costs incurred during past employees' service, the estimate incorporates average rates of inflation, returns on investment, and USPS pay increases granted during CSR participation. For the 1984-1989 period, assumptions are based on projections of CBO; for the period beyond the year 1989, assumptions conform to projections of the

9. The CBO estimated accrual cost of 20 percent of pay was derived from a Congressional Research Service model that estimates retirement costs for government-wide participation in CSR. Both the model and its results were adjusted to incorporate two factors: the past and projected wage history of USPS employees, including both negotiated raises and a separate schedule for raises assumed to result from career advancement; and the distribution of the USPS work force by sex and among current age and length-of-service groupings.

Social Security Administration. (The projections for the two periods show the following annual averages: interest, 10.7 percent and 6.1 percent; and inflation, as measured by the CPI, 4.5 percent and 4.0 percent.) For estimating purposes, the CBO calculations assume that future USPS wage rates, apart from career advancement, will keep pace with but not exceed increases in inflation and that benefit payments reflect current provisions, including those for COLAs in retirement annuities. The appendix table details the economic assumptions CBO used in estimating accrual costs.

Estimating the accrual cost on the basis of the current work force's characteristics--rather than on the characteristics of incoming new workers--is consistent both with accepted private-sector practice under existing federal regulations and with recent Social Security legislation that treats current and new federal employees differently. Unlike accrual cost estimates for new workers, those for the current work force depend less on projected economic conditions, because they build on historical data covering the years that employees have already participated in the system. Even so, however, they remain somewhat tentative, because USPS personnel (for reasons other than age and sex) may behave differently from all other participants in the CSR system. That is, at the same ages and lengths of service, USPS personnel may exhibit somewhat higher or lower rates of resignation, disability, or retirement. The nature and extent of such differences, however, are unknown, and thus they are not considered in the CBO estimate.

Estimate Comparison. The CBO estimate runs about 16 percentage points of pay lower than the most recent estimate--36.5 percent of payroll--published by the CSR Board of Actuaries (see Table 5). The higher estimate applies to **new** USPS and nonpostal entrants to the federal work force, rather than to the **current** USPS work force. As such, it uses constant factors for assumed future rates of change in interest, pay increases not associated with career growth, and benefit COLAs.

The lower CBO estimate results almost entirely from different economic assumptions. It incorporates both past experience and projected changes throughout postal employees' careers. (If the past and future wage growth assumptions reflected all current federal workers, rather than that for postal workers, the estimate would increase by some 25 percent.) The CBO estimate also incorporates certain other assumptions that, in combination, slightly raise the estimated cost. Costs rise somewhat because CBO uses a factor for greater improvement in participants' longevity than does the published estimate, and because the USPS work force has a greater

TABLE 5. SENSITIVITY OF ALL FEDERAL AND USPS RETIREMENT ACCRUAL COST ESTIMATES TO CHANGED ECONOMIC ASSUMPTIONS (In percent of payroll)

Economic Assumptions	Total Accrual Costs	Amounts Below (-) CSR Board of Actuaries' Estimates
ALL NEW FEDERAL EMPLOYEES		
7 Percent Interest, 6 Percent Inflation, 6.5 Percent Wage Growth a/	36.5	--
6.1 Percent Interest, 4 Percent Inflation, 5.5 Percent Wage Growth a/	30.8	-5.7
ALL CURRENT FEDERAL EMPLOYEES		
6.1 Percent Interest, 4 Percent Inflation, 5.5 percent Wage Growth a/	29.5	-7.0
Historical Data Included b/	24.8	-11.7
CURRENT USPS EMPLOYEES		
Actual and Projected Assumptions c/	20.0	-16.5

SOURCE: Congressional Budget Office from data provided by the Congressional Research Service.

a. Does not include wage growth attributable to career advancement.

b. Reflects actual annual rates of inflation and interest for the 1945-1983 period.

c. Reflects actual annual rates of inflation and interest for the 1945-1983 period, but incorporates USPS employees' wage growth. Future wage increases are expected to equal assumed rate of inflation (4 percent annually). Includes improved personnel life expectancy and administrative costs.

proportion of men. 10/ Different estimates of accrual costs, reflecting different demographic and economic assumptions, would of course change the estimates of the indirect subsidy.

RETIREMENT COSTS AND ANNUAL PAY ADJUSTMENTS

The current law does not require the USPS to fund fully the cost of federal retirement benefits not covered by employee contributions. In particular, the expense of post-retirement COLAs to benefits remains an obligation of the general taxpayer, rather than the postage rate payer. The added expense of future benefits arising from USPS pay raises, on the other hand, is funded both through the matching employer/employee payroll withholdings and through special payments, charged to the USPS; these amortize the remaining pay raise liability over 30 years. The cost recovery for retirement liability for pay raises has been the subject of debate with regard to when withholding and amortization payments begin for certain types of pay raises and to a lesser degree, to what interest rate should be used in determining amounts paid. The timing issue affects the near-term cash flow between the USPS and the Treasury, whereas the interest rate has near- and long-term effects that could change the levels of amortization payments assessed the USPS.

Analysis of the current mechanism for funding retirement liabilities for USPS pay raises should not overshadow the fact that the USPS is undercharged when cost effects of both post-retirement COLAs and pay raises are considered. The combined problems of interest rates and timing of payments to recoup pay raise liabilities would disappear if the USPS were charged for pension costs that more accurately consider all factors that affect future costs.

Timing of Reimbursement for Cost-of-Living Wage Adjustments

The USPS reimburses the CSR program for increases in future retirement liabilities resulting from any administrative actions or from

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10. Even though men receive benefits for a shorter time span because of their shorter life expectancies, the cost decreases are more than offset by greater cost increases attributable to more prevalent credits for military service, survivors' benefits, and to less job turnover. In addition, the CBO estimate includes two minor adjustments that reflect the distribution of USPS workers by age and length of service and the more uniform wage pattern for USPS career advancement than for the federal work force.

employee/management agreements that increase USPS pay. Under current practice USPS payments to the CSR system to fund negotiated wage COLAs usually start three years after the COLAs are first received. (No delay occurs for other negotiated wage increases stipulated in labor contracts.) Some observers believe that this delay provides the USPS with an indirect subsidy. But if the three-year cycle for wage COLAs is viewed as a recurring practice, the delays do not appear to create a long-run shortfall in USPS payments to the CSR fund. On the other hand, requiring the USPS to make payments promptly--that is, when wage COLAs are granted--would increase payments to the Treasury in the short run and thus would help, (though probably at the expense of slightly higher postage rates) to reduce the federal budget deficit.

The current practice of delaying wage COLAs for purposes of retirement evolved because labor agreements treat COLAs as temporary measures that do not increase retirement liabilities. The delay in adding wage COLAs to basic pay depresses the calculation of average "high-three" salary used for calculating some annuities. (That is, calculating a retiree's annuity on the basis of the average of his or her highest three years of pay.) This, in turn, lowers the size of future benefits for workers retiring during the period of delay and thus, the long-term liabilities arising from pay raises. As an ongoing practice that continues in future years, unpublished estimates show (in present value terms) the decline in long-term liabilities because of delay in adding wage COLAs to basic pay proportional to the loss of income from delay in withholding and amortization payments. 11/

Because timing does not affect long-term liabilities, the Office of Personnel Management though responsible for maintaining the financial integrity of the CSR fund--does not object to future contracts' following the practice of three-year delays in USPS payments. But with regard to the one exception in the July 1978-1981 cycle--potentially delaying wage COLAs for six years--OPM maintains that, if the COLAs are now rolled into basic pay under terms of the upcoming contract, the USPS should make compensatory payments for three of the six years delayed. In particular, OPM would expect to receive three years' interest on the deferred amortization payments and employee and employer contributions, with interest, for the three-year loss.

Although the USPS does not expect the forthcoming labor agreements to roll in previous wage COLAs, if they do, the USPS agrees only in part to

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11. CBO analysis of the present value of benefits and income associated with alternate scheduling of pay raises confirms detailed results reached by OPM actuaries' comprehensive actuarial projection.

OPM's compensatory approach. The USPS would accept OPM terms for interest on delay of amortization payments but not for making up employer/employee withholdings forgone. The USPS points out that it has no authority either to recoup funds from employees--however extraordinary a six- rather than three-year delay may be in OPM's view--nor to depart from the employer matching requirement contained in current law.

Short-Term Payments Avoided. Although the current system for funding USPS wage COLAs does not appreciably alter the long-term liabilities recouped by the CSR fund, the delay mechanism does lower--relative to retirement funding of other USPS pay raises--near-term cash receipts to the Treasury. For wage COLAs not yet rolled in, notably those received since July 1978, the USPS and its employees have avoided paying into the CSR fund some $2.5 billion (in 1984 dollars) because of delays in timing of payroll withholdings and amortization payments (see Table 6).

From the standpoint of deficit reductions, the USPS could make up the past avoidance of near-term payments, calculated without delay and using the 5 percent interest rate stipulated under current law. If, from this perspective, the accumulated short-term payments avoided were amortized over 30 years and delays from employee contributions excluded, annual catch-up payments by the USPS would begin at some $0.1 billion in 1985. As the USPS has claimed, however, such a plan would logically require OPM to increase the benefits of employees who unexpectedly retired during the periods prior to the COLA roll-ins. The scheme also leaves unresolved the need to place all aspects of USPS retirement financing on an accrual basis that associates costs with current work being performed.

Sensitivity of Amortization Payments to Interest Rates. As is the case in estimating accrual costs, economic assumptions greatly influence the estimated CSR liability caused by negotiated pay raises and the associated amortization payments. During the eight years that the USPS has made out-of-pocket reimbursement to CSR for liabilities arising from negotiated pay raises, the calculation of the amounts paid has incorporated a 5 percent interest rate. 12/ (For the purposes of amortizating liabilities from postal pay raises, the wage adjustments and interest rates used are both in nominal terms that include inflation.) Beginning in 1980, monthly

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12. Beginning in 1974 the USPS was required to make 30-year amortization payments toward the retirement liability arising from postal pay raises, but in the first two years federal appropriations to the USPS helped defray some of the cost during transition to the new expense. In 1976, the entire cost of 30-year payments was paid from USPS funds without any earmarked supplemental federal funds.

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TABLE 6. COMPARISON OF USPS CONTRIBUTIONS TO CSR FOR WAGE COLAs, UNDER CURRENT AND EARLIER PAYMENT PRACTICES, 1979-1984 (In billions of 1984 dollars) a/

Type of Payment	1979	1980	1981	1982	1983	1984	Six-Year Total
				CURRENT PRACTICE			
Employee	1.2	1.1	1.1	1.1	1.0	0.9	6.3
Agency	1.2	1.1	1.1	1.1	1.0	0.9	6.3
Amortization	1.0	1.0	1.0	1.1	1.1	1.0	6.2
Total	3.4	3.3	3.1	3.2	3.0	2.8	18.8
				EARLIER PAYMENTS			
Employee	1.2	1.2	1.2	1.2	1.1	1.0	6.9
Agency	1.2	1.2	1.2	1.2	1.1	1.0	6.9
Amortization	1.1	1.2	1.2	1.3	1.3	1.7	7.5
Total	3.5	3.6	3.6	3.7	3.6	3.3	21.4
				DIFFERENCE			
Employee	b/	0.1	0.1	0.1	0.1	0.1	0.6
Agency	b/	0.1	0.1	0.1	0.1	0.1	0.6
Amortization	0.1	0.2	0.3	0.3	0.3	0.3	1.3
Total	0.1	0.3	0.5	0.5	0.6	0.5	2.5

SOURCE: Congressional Budget Office from data supplied by the USPS.

NOTE: Details may not add to totals because of rounding.

a. Amounts are converted to 1984 dollars using marginal rates of return experienced by the CSR trust fund in 1979 through 1984.

b. Less than $50 million.

rates of return on new CSR investments have ranged between 9 percent and 15 percent, with an average annual return of 12 percent. Overall, the investment weighted annual return on all CSR assets during the last four years (1980-1983) increased from 8 percent to 10 percent.[13]

What interest rate should be used to calculate retirement liabilities resulting from USPS pay increases? The law leaves that determination up to the CSR Board of Actuaries. Historically, the average yield of CSR investments has helped determine the rate selected by the board.[14] But the last two evaluations--in 1972 and 1977--discontinued this linkage. If it had continued, the 1977 valuation would have replaced the 5 percent rate with a 7 percent annual interest rate. Based on the higher rates the annual amortization amounts paid by the USPS would drop. (The decline in the annual payments is slightly offset by an increase in the amortization schedule due to higher interest rates.) In short, the higher interest rate would cause the estimated liability (in current dollars) to shrink noticably because of recognition of the greater earning power of money over time. In other words, the present value of a dollar of liability not coming due until years later declines with a rise in the interest rate, which represents opportunities to use the dollar productively in the interim.[15]

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13. When calculating CSR accrual costs, the relationship between the underlying economic assumptions is more important than the absolute level. The CBO used inflation-adjusted interest rates that, in the long term, correspond to the 2.1 percent real rate of investment used by the Social Security Board of Actuaries. The 2.1 percent rate (interest less inflation) is more than double the 1.0 percent assumption adopted by the CSR Board of Actuaries in 1977.

14. The actual investment-weighted return of CSR assets increased during 1970 from 4.62 percent to 5.16 percent. In response, the interest rate for the 1970 evaluation was increased to 5 percent from 3.5 percent, the rate used in the immediately preceding evaluation of 1965.

15. A forthcoming CBO paper will consider the CSR investment mechanisms, alternatives to them, and effects on sources of funding. At present, most of the CSR fund is invested in special non-marketable securities that mainly represent internal governmental accounting entries.

CHAPTER III. OPTIONS FOR CURTAILING THE INDIRECT SUBSIDIES

Improved cost accounting would be the primary goal achieved by reducing or eliminating the U.S. Postal Service's indirect subsidies for retirement pensions and health coverage. Advocates of such steps would also point to secondary benefits, such as improved efficiency in the use of USPS service and heightened competition between the USPS and private firms. Reduction of the federal budget deficit would also follow, though not on a major scale. This chapter analyzes three possible courses for accomplishing these goals.

- **Option I--Recoup annuitants' health-benefit costs** for newly retired postal employees by charging the USPS the difference between full premium costs and the annuitants' contributions;

- **Option II--Recoup pension costs** on an accrual basis by charging the USPS the difference between the full accrual cost and the employees' contributions; or

- **Option III--Recoup both** annuitants' health-benefit and active employees' pension costs.

In favor of the status quo, the USPS might argue that no ordinary federal agency is fully charged for Civil Service Retirement, nor for annuitants' health coverage. The USPS ought not have to pay for benefits decided by the Congress rather than through negotiations by itself and its own work force. Any curtailment of the indirect subsidies would require the Congress to amend current law. Each of the options CBO has examined would curtail the USPS's indirect subsidies by increasing the service's contributions to federal benefit programs. Options I and II, covering health and retirement costs in that order, are independent but could be blended in the combination that produces Option III. Of course, the Congress could modify some of the measures outlined here to fit particular objectives. 1/ The CBO has analyzed all three options with respect to their advantages and disadvantages, their possible effects on USPS personnel costs and service rates, and their potential effects on the federal budget.

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1. By an altogether different approach, the subsidies could instead be limited by measures that reduced benefits, increased employees' contributions, or allowed the USPS to shift from participation in governmentwide benefit programs by instituting its own benefit

EFFECTS ON THE FEDERAL BUDGET

By shifting certain USPS compensation costs from taxpayers in general to postage ratepayers in particular, Option I by itself could reduce federal budget deficits by some $0.4 billion over five years' time. Option II would yield a much greater five-year budgetary savings of $2.6 billion. And of course, Option III, being a combination of Options I and II, would offer cumulative savings of $3.0 billion (see Table 7). CBO's estimates assume the options would take effect in the beginning of 1985, about two months after the expiration of labor/management agreements now in force. Under each approach, reductions in budgetary deficits would result from increased contributions from the USPS; the federal budget treats these contributions as offsetting receipts, which reduce net federal outlays. 2/

For each option, reductions in budgetary outlays described represent net amounts that have been adjusted to reflect certain secondary effects. Higher payments from the USPS for annuitants' health and retirement benefits would in part be passed on to the government through an increase in the postage rates the government pays as a user of mail service. In addition, higher rates for not-for-profit and other subsidized mailers could--if Congressional appropriations permitted--increase the cost to the government of direct appropriations that make up revenue forgone on free and reduced-rate mail (see Chapter I). Together, these two secondary effects would have negligible influence on the deficit reductions.

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systems through collective bargaining agreements. Debate about an emerging separate retirement program for federal employees hired after December 31, 1983 may raise the issue of allowing the USPS to set up its own program--at least for new employees. Such a separation could cause the federal deficit to rise in the short run because of revenue losses from altered employee and USPS payments to the CSR trust fund. Plans would not likely be considered, however, until after the Congress has resolved the integration of Social Security and supplemental benefits for all new federal workers.

2. The USPS's payments for annuitants' health benefits reduce outlays for government payment for annuitants' health coverage (function 550); USPS payments for pension costs show up as receipts from off-budget federal entities (function 950).

TABLE 7. PROJECTED FEDERAL DEFICIT REDUCTIONS RESULTING FROM OPTIONS TO ELIMINATE INDIRECT SUBSIDIES TO THE USPS, 1985-1989 (In billions of dollars)

	1985	1986	1987	1988	1989	Cumulative Five-Year Reductions a/
Option I -- Recoup Annuitants' Health-Benefit Costs	b/	b/	0.1	0.1	0.1	0.4
Option II -- Recoup Pension Costs	0.2	0.4	0.6	0.7	0.6	2.6
Option III -- Recoup Annuitant Health-Care and Pension Costs	0.3	0.5	0.7	0.8	0.8	3.0

SOURCE: Congressional Budget Office.

a. Details may not add to totals because of rounding.

b. Less than $50 million.

OPTION I--RECOUP HEALTH-BENEFIT COSTS FOR POSTAL ANNUITANTS

Under this approach, the USPS would be charged for the annual federal cost of health-insurance premiums for newly retired postal employees. The federal cost, representing the difference between the full premium and the annuitants' contribution, accounts for roughly 55 percent of the cost of the health-benefit premium. Higher contributions from the USPS would reduce the federal budget deficit by $20 million in 1985 and by a total of $0.4 billion over the five-year 1985-1989 period. The increase in operating costs to

the USPS, corresponding roughly to the federal deficit reduction, would be relatively small--raising average annual operating costs through 1989 by less than 0.5 percent.

Proponents of this option argue that, as a semi-independent organization, the USPS should bear the cost of annuitants' health-care benefits just as do private-sector competitors that offer comprehensive health benefits to their retirees--commonly at little or no cost to beneficiaries. 3/ Opponents note that the option would legislatively impose reforms on the USPS to which no ordinary federal agency would be subject. (According to one counterargument, however, charging most other agencies for annuitants' health-benefit costs would presumably increase their appropriations and result in internal transfers with no net budgetary effects.)

As an alternative to bearing the federal share of annuitants' health-benefit costs, the USPS might argue for the right to withdraw from the federal program and negotiate its own health-benefit package. Last year, the USPS contracted with an actuarial accounting firm to study the feasibility and costs of just such an alternative. For the time being, however, the USPS has recently decided to forgo the idea. If the USPS should withdraw from CSR, the long-term budgetary reductions of this option would not change, so long as the new system applied to current employees, both before and after retirement. (Discontinuation of participation in FEHB could, however, result in some transition costs to the federal government related to the disposition of certain reserves held in the FEHB trust fund. 4/)

OPTION II--RECOUP PENSION COSTS ON AN ACCRUAL BASIS

This approach calls for charging the USPS for the full estimated accrual cost of the CSR system not covered by postal employees' contributions. According to current CBO estimates, the USPS would pay the CSR

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3. Most large private-sector employers pay full health-insurance premiums for their employees and annuitants; at retirement, however, the benefits and therefore the costs are lowered, mostly reflecting integration with Medicare. See U. S. House of Representatives, Committee on Post Office and Civil Service, Review of the Federal Employees Health Benefits Program (January 28, 1983).

4. See Congressional Budget Office, Reducing the Reserves.

program an amount equivalent to 13 percent of payroll--the 20 percent full accrual cost, less the 7 percent withholding from employees' pay. 5/ Because the calculation of the accrual rate includes the increased retirement liability associated with future pay raises, the periodic payment under Option II would replace the existing employers' contribution of 7 percent of pay and would arrest the growth in all special USPS amortization payments for liabilities attributable to future negotiated pay raises. Employee contributions, remaining at the statutory rate of 7 percent of pay, would continue to be calculated on the payroll basis used under current practice.

The net effect of the accrual recoupment alternative would increase USPS annual operating costs in 1985 by some $0.9 billion, or about 3 percent, if fully implemented by October 1, 1984. To moderate the initial impact, Option II would gradually phase in requirements for full funding over a four-year period. On this basis, the increased annual cost to the USPS would start at some $0.2 billion, but the amount would grow to $0.7 billion upon full implementation in 1988. The net budgetary reduction through 1989 is estimated to reach some $2.6 billion, considering secondary cost increases for postage paid by the Internal Revenue Service, the Social Security Administration, and other federal agencies. This relatively small increase in USPS operating costs--less than 2 percent in 1989--could add to pressure to increase postage rates. Eventual rate effects, incorporating mail volume impacts, might average some 5 percent, for example, increasing the price of a first-class stamp by one cent.

Charging the USPS the accrual cost of CSR would be similar to recent Congressional action taken on the retirement program for military personnel. 6/ Such a requirement would also be consistent with USPS accounting

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5. The estimated contribution rate considers both the characteristics of the current USPS work force, rather than the whole federal work force, and the immediate impact of COLAs to postal wages. This rate differs from those used by CBO in earlier studies; see Congressional Budget Office, Reducing the Deficit: Spending and Revenue Options (February 1984) pp. 139-140 and see Congressional Budget Office and General Accounting Office, Analysis of the Grace Commission's Major Proposals for Cost Control (February 1984) pp. 263-265.

6. The 1984 Department of Defense Authorization Act requires an accrual accounting system for military retirement benefits. Under the law's provisions, the full accrual costs of retirement for uniformed military personnel would be recognized in current budgets. For a discussion of accrual accounting for defense agencies, see Congressional Budget Office, Accrual Accounting for Military Retirement: Alternative Approaches (July 1983).

practices that report costs on an accrual basis, and with financing practices used by many private-sector firms under the Employee Retirement Income Security Act of 1974 (ERISA). Option II, in fact, would impose financing requirements on the USPS that are less stringent than ERISA's, because the recoupment cost would not include unpaid liabilities predating conversion to full funding. 7/ Critics of this option would contend, however, that the USPS is not so similar to private-sector firms as it is to ordinary federal agencies, which are not charged for the full costs of retirement.

Opponents of Option II cite the difficulties of estimating accrual costs. Even slight changes in economic and actuarial assumptions used in estimating accrual costs, they argue, could mean significant increases or decreases in USPS operating budgets. Such critics point out, moreover, that no one has ever conducted a comprehensive actuarial valuation of the accrual cost of CSR as it applies to the USPS work force. Some of these concerns could be accommodated by including USPS representation on the CSR Board of Actuaries and by charging the board with responsibility for preparing cost estimates relating to postal participation. 8/ Critics might also advocate postponing any action on USPS retirement charges pending completion of labor contract negotiations already in progress and Congressional action on several CSR reform proposals. Proposals are now being considered by Congress to integrate Social Security and CSR for federal employees hired after December 1983. 9/

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7. If the USPS were required to cover its estimated share of unpaid liabilities for existing employees and annuitants as of September 30, 1983, an annual additional charge of some $2.3 billion might be assessed (assuming amortization of statutory unfunded liabilities over 40 years at a 5 percent interest rate).

8. Under current law, the three-member CSR Board of Actuaries is appointed by OPM. Allowing the Postmaster General to make recommendations for a seat on the board would provide for USPS representation.

9. H. R. 2077, approved by the Congress in November 1983, provides a temporary reduction in contributions for newly hired federal employees either until a new pension program is enacted or by January 1, 1986, whichever comes first.

OPTION III--RECOUP ANNUITANTS' HEALTH-BENEFIT AND PENSION COSTS

Combining Options I and II, this approach would be the most comprehensive--completely eliminating the indirect subsidies for USPS annuitants' health-benefits and pensions. Higher contributions from the USPS would reduce the federal budget deficit by $0.3 billion in 1985 and by $3.0 billion over 1985-1989 period. In the first year, however, it would increase USPS operating costs by less than 1 percent, and that increase could grow to less than 2 percent by the fifth year.

Effects on Postage Rates and Mail Volume. With indirect subsidies eliminated, higher USPS operating costs could lead to postage-rate increases and mail-volume decreases. Estimating the rate and volume effects is complicated by the often uncertain relationships between postage rates and volume, and by the effects of other variables--such as changes in the economy (as measured by "disposable" personal income), and in the numbers of new households. As a result, estimates should be viewed not as precise calculations but as general orders of magnitude. 10/

Overall, curtailing pension and annuitants health-benefit subsidies could eventually increase rates by approximately 5 percent, on average. Effects on rates by class of mail would vary little: only fourth class--about half of which consists of parcel post--would show even a slightly lower rate effect. The results showing an otherwise essentially uniform effect reflects the fact that retirement costs (used by CBO to determine the subsidies' distribution and influence) make up about equal portions of the total costs attributable to each general class of mail. Because businesses and other non-residential mailers do almost 85 percent of today's mailing, they would be affected the most by higher postage rates. Together with households, these mailers' use of the USPS might average about 2 percent less than it would if the USPS continued to receive no indirect subsidies.

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10. To approximate the postage-rate and volume effects of the indirect subsidies, CBO developed a relatively simple revenue cost model, which incorporates assumptions about the behavior of key aspects of USPS operations. The assumptions, consistent with those made for the last postage-rate case, cover the relationship between two sets of variables--rates and volume, and fixed and variable costs. The relationships were applied against the most recent comprehensive USPS data (1982) on rates, volume, costs, and revenue. See U.S. Postal Rate Commission, Opinion and Recommended Decisions (February 1981), U.S. Postal Service, Cost Segments and Components for Fiscal Year 1982 (June 1983) and Revenue and Cost Analysis for Fiscal Year 1982 (June 1983).

As with rates, results showing volume effects vary little by postal class. Consistent with assumptions used by the Postal Rate Commission in analyzing the USPS's 1981 request for general rate increases, the responsiveness of volume to changes in postage rates--or in economists' jargon, its "elasticity"--varies little by class. Only fourth-class mail shows a different, slightly higher, effect on volume. This class traditionally demonstrates greater sensitivity to rate changes, reflecting in part the availability of highly competitive private-sector alternatives to USPS service. Though a scarcity of reliable marketing data makes firm conclusions difficult to establish, unsubsidized rates might slightly increase the competition the USPS faces. Any rise in postage rates likely to attend elimination of the indirect subsidies might somewhat reduce the share of the communications industry the USPS holds, with the lost portion being picked up by private-sector competitors. Three categories of service, generating about one-quarter of USPS revenues, face particularly strong private-sector competition--expedited mail handling, parcel delivery, and bulk and other mail advertising. Differences in service quality, however, undoubtedly play a more important role in winning or losing customers than actual rates do.

APPENDIX

APPENDIX TABLE A. ECONOMIC ASSUMPTIONS USED IN ESTIMATING ACCRUAL COSTS, 1945 THROUGH 1995
(In percents)

Fiscal Years	Interest	Inflation	Wage Increases for All Current Workers	Wage Increases for All Current USPS Employees
1945-1952	4.0	a/	8.0	11.8
1953-1956	3.5	a/	1.6	2.0
1957-1960	3.0	a/	3.2	2.5
1961-1964	3.0	a/	4.0	4.8
1965-1968	3.5	3.9 b/	3.9	4.5
1969-1972	5.0	4.8	7.9	8.2
1973	6.0	6.1	5.5	6.2
1974	6.0	5.8	7.2	10.5
1975	6.0	6.4	7.0	9.2
1976	6.0	5.2	6.6	7.2
1977	6.8	4.6	6.8	9.6
1978	7.0	3.6	7.1	6.8
1979	7.7	5.4	5.9	7.2
1980	8.3	6.8	8.0	11.0
1981	9.1	4.4	8.7	7.7
1982	10.2	8.7	4.6	3.9
1983	10.4	3.9	3.9	3.6
1984	10.6	3.3	4.1	4.4
1985	10.7	4.9	3.7	5.1
1986	10.7	4.9	5.3	4.9
1987	10.8	4.9	5.4	4.8
1988	10.8	4.6	5.3	4.5
1989	10.7	4.5	5.3	4.3
1990	9.8	4.0	5.5	4.0
1991	8.9	4.0	5.5	4.0
1992	7.9	4.0	5.5	4.0
1993	7.0	4.0	5.5	4.0
1994	6.1	4.0	5.5	4.0
1995 and Beyond	6.1	4.0	5.5	4.0

SOURCE: Congressional Budget Office from data provided by the USPS, OPM, U.S. Budget, Appendices (1962-1978), Monthly Statements of the Public Debt (June 1976-January 1984), and U.S. House of Representatives Committee on Post Office and Civil Service Print 98:10 (January 31, 1984).

a. Before 1967, COLAs were granted on an ad hoc basis and were not uniform among all CSR retirees.

b. Includes 1967 and 1968 adjustments of 3.9 percent each.

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